FILED
AUG 22 1959
JAMES R. BROWNING, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 1

ROBERT AQUILINO and JOSEPH SPERO, doing business as HOME MAINTENANCE COMPANY, Petitioners

v.

UNITED STATES OF AMERICA, ADA BOTTONE, FLEETWOOD PAVING CORPORATION, and COLONIAL SAND AND STONE CO., INC.

COLONIAL SAND AND STONE CO., INC., Petitioners

v.

UNITED STATES OF AMERICA, ADA C. BOTTONE, doing business as MARIO'S MIRAMARE RESTAURANT,

FLEETWOOD PAVING CORPORATION, ROBERT AQUILINO and JOSEPH SPERO, doing business as HOME MAINTENANCE CO.

ON WRIT OF CERTIORARI TO THE COURT OF APPEALS OF THE STATE OF NEW YORK

BRIEF FOR THE PETITIONERS

CHARLES S. FRIEDMAN,
Attorney for Petitioners,
Aquilino & Spero,
10 Fiske Place,
Mount Vernon, N. Y.

JACOB I. GOODSTEIN,
Attorney for Petitioner,
Colonial Sand & Stone Co., Inc.,
21 East 40th Street,
New York, N. Y.

HAROLD M. EDWARDS,
KENNETH J. BRESKIN,
Of Counsel.

COPY BOUND CLOSE IN CENTER

INDEX

	PAGE
Opinions Below	1
Jurisdiction	2
Question Presented	2
Statutes Involved	2
Statement	3
Summary of Argument	5
Argument	9
A. The Statutory Trust	10
B. The Mechanic's Lien	25
C. Lien Priority	27
Conclusion	34
Appendix:	
(a) The Federal Lien for Taxes	35
(b) The New York State Lien Law	38

CITATIONS

Cases:

Aetna Cas. & Sur. Co. v. *United States*, 4 N. Y. 2d 639 ..... 13, 20

Albert Pick Co., Inc. v. *Travis*, 6 F. Supp. 486 .. 17

Barter v. *Hawksworth*, 102 Misc. 242, 169 N.Y.S. 475 14

Bray Bros. v. *Maine Trust Co.*, 35 N.Y.S. 2d 356 15

Century Indemnity Co. v. *Bank of Gowanda*, 35 N.Y.S. 2d 396, affd. 263 App. Div. 1068, 35 N.Y.S. 2d 463 15

PAGE

Commissioner v. *Stern*, 357 U. S. 39 ..... 8, 29
Corbin-Kellogg Agency, Inc. v. *Tasker*, 248 App. Div. 58, 289 N. Y.S. 156 ..... 6, 14, 33
Cranford Co. v. *L. Leopold and Co.*, 298 N. Y. 676, 82 N. E. 2d 580, affirming 273 App. Div. 754, 75 N.Y.S. 512, affirming 189 Misc. 388, 70 N.Y.S. 183 15

Einach's Estate, In re, 1 Misc. 2d 537, 146 N.Y.S. 2d 240 ..... 6, 14
Ellis' Estate, Matter of, 110 Misc. 192, 179 N.Y.S. 873 14
Erie R. Co. v. *Tompkins*, 304 U. S. 64 12
Fidelity and Deposit Company of Maryland v. *New York Housing Authority*, 241 F. 2d 142 ..... 6, 7, 10, 18, 19, 20
Franklin, Matter of, 26 Misc. 107, 56 N.Y.S. 858 14

Heintzelman Construction Co., In re., 34 F. Supp. 109 17

Herrmann v. *Rogers*, 358 U. S. 332 9

Morgan v. *Commissioner*, 309 U. S. 78 6

Powers' Estate, Matter of, 75 Misc. 85, 134 N.Y.S. 967 14

Rosicato v. *Manera*, 192 Misc. 607, 81 N.Y.S. 2d 353 15

Stiles' Estate, In re, 126 Misc. 715, 215 N.Y.S. 134 14

Treister & Sons, Inc., In re, 145 F. Supp. 144 .. 17

United States v. *Acri*, 348 U. S. 211 31
United States v. *Bess*, 357 U. S. 51 6, 7, 9, 12, 13, 16, 18, 26
United States v. *City of New Britain*, 347 U. S. 81 30

COPY BOUND CLOSE IN CENTER

PAGE

United States v. *Colotta*, 350 U. S. 808 31
United States v. *Gilbert Associates*, 345 U. S. 361 30
United States v. *Kings County Iron Works, Inc.*, 224 F. 2d 232 .....7, 18, 19, 32
United States v. *Liverpool & London & Globe Insurance Co.*, 348 U. S. 215 31
United States v. *R. F. Ball Construction Co.*, 355 U. S. 587 15
United States v. *Scovil*, 348 U. S. 218 31
United States v. *Security Trust and Savings Bank*, 340 U. S. 47 .....8, 12, 25, 27, 28, 30
United States v. *Vorreiter*, 355 U. S. 15 .....25, 31
United States v. *White Bear Brewing Co.*, 350 U. S. 1010 31

Wade v. *Nassau Suffolk Lumber and Supply Corp.*, 275 App. Div. 864, 89 N.Y.S. 2d 294 .. 15
Waldman v. *D. & V. Plumbing & Heating Contractors, Inc.*, 102 N.Y.S. 2d 787 .....6, 8, 13, 33
Washington Square Slum Clearance, In re v. *United States* v. *Coblentz*, 5 N. Y. 2d 300 ..6, 9, 13
Wickes Boiler Co., Inc. v. *Godfrey-Keeler Co., Inc.*, 121 F. 2d 415 (reversing 116 F. 2d 842 certiorari denied, 314 U. S. 686 ..... 7, 16

tutes:

Bankruptcy Act:

Section 64 a (5), 11 U.S.C. 104 a (5) 7, 8, 16
Section 70 a, 11 U.S.C. 110 a 6, 8, 15, 16

Internal Revenue Code of 1939:

Section 3670, 11 U.S.C. (1952 ed.) 3670 ..2, 3, 8, 9, 10, 11, 15, 16, 17, 19, 21, 27, 28, 29, 32
Section 3671, 26 U.S.C. (1952 ed.) 3671 ...3, 17, 27
Section 3672, 26 U.S.C. (1952 ed.) 3672 ...8, 14, 15, 17, 18, 27, 28, 32

PAGE

Internal Revenue Code of 1954:
Section 6321, 11 U.S.C. (1952 ed., Supp. II) 6321 3
Section 6322, 11 U.S.C. (1952 ed., Supp. II) 6322 3
Section 6323, 11 U.S.C. (1952 ed., Supp. II) 6323 3

New York Lien Law:
Section 3 4,10
Section 36a (Repealed L. 1959 c. 696, § 14) . . 3, 4, 6, 10, 11, 13, 15, 16 22, 23, 24
Section 55 ..... 7, 25
Section 56 ..... 7, 25
Section 70, L. 1959, c. 696 ..... 11, 24
Section 71, L. 1959, c. 696 11

31 U.S.C. 191 (R. S. 3466) 14 27, 28, 30

Miscellaneous:
"Act, Recommendation and Study relating to the Fund Provisions of the Lien Law," 1942 Report, New York State Revision Commission 6, 12
Black's Law Dictionary, 3rd Ed. 32
Brief for United States in Opposition to Petition for a Writ of Certiorari, *Aquilino* v. *United States*, ... 9, 13
H. R. Report No. 1018, 62nd Cong., 2d Sess. (1912) 8, 28, 29
Scott on Trusts, 1956 Ed., Vol. II, § 120 22
Scott on Trusts, 1956 Ed., Vol. IV, § 30.2 22
"Trust Fund Provisions of the Lien Law", 1959 Leg. Doc. No. 65(F) 11, 24

COPY BOUND CLOSE IN CENTER

IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 1

ROBERT AQUILINO and JOSEPH SPERO, doing business as HOME MAINTENANCE COMPANY, Petitioners,

v.

UNITED STATES OF AMERICA, ADA BOTTONE, FLEETWOOD PAVING CORPORATION, and COLONIAL SAND AND STONE CO., INC.

COLONIAL SAND AND STONE CO., INC., Petitioners,

v.

UNITED STATES OF AMERICA, ADA C. BOTTONE, doing business as MARIO'S MIRAMARE RESTAURANT,

FLEETWOOD PAVING CORPORATION, ROBERT AQUILINO and EPH SPERO, doing business as HOME MAINTENANCE CO.

BRIEF FOR THE PETITIONERS

Opinions Below

he opinion of the New York Court of Appeals (R., p. is reported at 3 N. Y. 2d 511, 146 N. E. 2d 774. The ion of the Appellate Division, Second Department

(R. 62) is reported at 2 A. D. 2d 747, 153 N.Y.S. 2d 268. The opinion of the Supreme Court, Westchester County (R. 52) is reported at 140 N.Y.S. 2d 355.

Jurisdiction

The judgment of the New York Court of Appeals was entered on December 5, 1957 (R. 70). A motion for rehearing was denied and the remittitur amended on April 3, 1958 (R. 72). The jurisdiction of this Court is invoked under 28 U.S.C. 1257 (3).

Question Presented

Section 3670 of the Internal Revenue Code of 1939 imposes a tax lien on all "property and rights to property" of a defaulting taxpayer. Under New York law, "the right of action upon an obligation for moneys due or to become due to a contractor, as well as moneys actually received by him", arising from the improvement of real property, constitute trust funds for the benefit of subcontractors, laborers and materialmen, to the extent of their unpaid claims for the work, labor, services and material, the furnishing and rendition of which created the credit-fund or moneys paid over.

The question presented is whether the general contractor's interest, solely as trustee, in the res of this statutorily-created trust constitutes "property" or "rights to property" under the federal tax lien law.

Statutes Involved

The pertinent provisions of the federal tax lien law and the New York law are set forth in an appendix, *infra*, pages 35-38.

COPY BOUND CLOSE IN CENTER

Statement

Petitioners are subcontractors, laborers and materialmen who are statutory beneficiaries of a trust under New York Lien Law, Section 36-a, *infra*, page 38. They instituted two separate suits in the New York Supreme Court, Westchester County, to enforce their rights under the Lien Law. By stipulation of counsel, the two cases were heard and tried together both in the trial court and in the subsequent appeals (R. 48).

The undisputed facts may be summarized as follows: On December 27, 1951, the Collector of Internal Revenue, Albany District, received an assessment for unpaid withholding taxes against Fleetwood Paving Corporation in the amount of $4,464.70 (R. 46). On March 21, 1952 the Collector received an additional tax assessment against Fleetwood, this time in the amount of $3,168.00 (R. 46). Under the provisions of 26 U.S.C. (1952 ed.) and 3670 and 3671,[1] *infra*, page 35, the United States obtained a statutory lien on all the taxpayer's "property and rights to property" by virtue of the Collector's receipt of these assessments.

Subsequently, the taxpayer contracted with Mrs. Ada Bottone to make certain improvements on her newly-acquired restaurant which she styled Mario's Miramare Restaurant (R. 43).[2]

On August 25, 1952, the taxpayer entered into a subcontract with petitioners Aquilino and Spero, doing business as Home Improvement Company (R. 19), under which these petitioners agreed to rebuild the front porch and

---

[1] These provisions are incorporated in the Internal Revenue Code of 1954 as 26 U.S.C. (1952 ed., Supp. II) 6321 and 6322.

[2] The exact date of this contract does not appear in the record. However, it necessarily occurred subsequent to July 8, 1952, the date on which Ada Bottone acquired title to the restaurant (R. 43). In any event, the exact date of this contract is immaterial.

reservice the walls, floor and steps of the side porch of Mrs. Bottone's restaurant (R. 19). Petitioners Aquilino and Spero performed the subcontract, but remain unpaid in the amount of $1400.00 (R. 17). Under New York Lien Law, Section 36-a, petitioners Aquilino and Spero are beneficiaries of a trust consisting of (a) the right of action for moneys due or to become due to the contractor from Mrs. Bottone, and (b) any moneys actually paid to him, and under New York Lien Law, § 3, they have a lien against the real property improved, and they subsequently instituted this suit to enforce their rights (R. 15-19).

Sometime between October 2 and October 8, 1952, petitioner Colonial Sand and Stone Co., Inc. sold to the taxpayer, Fleetwood, some stone and cinders for use in the construction which the taxpayer had undertaken in connection with its contract with Mrs. Bottone (R. 40). The agreed purchase price for this material was $896.25 (R. 40). The taxpayer failed to pay Colonial (R. 40) and it too filed suit to enforce its rights under the New York Lien Law (R. 22-27).

In her answer in each of the actions, Mrs. Bottone admitted that she owed $2,200.00 for the improvements made by petitioners as subcontractors and materialmen of the defaulted taxpayer, but stated that the United States had served notice of its assertion of a tax lien against such fund (R. 20-21, 28-29). She then filed a motion requesting that both actions be dismissed as to her upon her deposit of the $2200.00 with the Clerk of the County, and that the United States be substituted as a party defendant in view of its assertion of a right to the fund superior to petitioners' (R. 32-33). The motion was granted, and the court ordered deposit of the $2200.00 with the Clerk of the County, the substitution of the United States as party defendant, and service of the order on the United States (R. 32-33). The Government subsequently filed answers in each suit asserting that its tax lien gave it rights in the fund superior to

COPY BOUND CLOSE IN CENTER

petitioners' (R. 33-38). By stipulation of the parties, both cases were heard and tried together (R. 31).

Petitioners Aquilino and Spero, petitioner Colonial Sand and Stone Co., Inc. and the Government each moved for summary judgment (R. 8-10, 38-39, 45). The trial court ruled that petitioners' interest in the fund, which consisted of the money deposited with the Clerk, prevailed against the Government's tax lien and ordered pro rata distribution of the money between petitioners Aquilino and Spero and petitioner Colonial Sand and Stone Co., Inc. (R. 52-53). The Government appealed to the Appellate Division of the Supreme Court which affirmed (R. 62-64). A unanimous court ruled that "there is, at present, no debt due and owing from Bottone to [the taxpayer] to which [the Government's] lien may attach" (R. 63). The Government thereupon appealed to the New York Court of Appeals, which reversed, ruling that the funds, constituting Mrs. Bottone's indebtedness for the improvements made to her restaurant by the petitioners were "quite obviously within the statutory terms 'property and rights to [such] property' belonging to the taxpayer" (R. 68). While indicating in a footnote that one of its own opinions suggests a contrary conclusion, the court felt obliged to follow what it considered to be indications in the opposite direction in more recent federal opinions (R. 69). Van Voorhis, J., dissented. Petitioners' motion for rehearing was denied but on petitioners' motion the remittitur was amended (R. 72-73). The petition herein for a writ of certiorari to the Court of Appeals of the State of New York was granted on February 24, 1959 (R. 82).

Summary of Argument

A. Determination of what constitutes "property" or "rights to property" when applying § 3670, 11 U.S.C. 3670 may be made only by reference to state law, since the federal lien statute "creates no property rights but merely

attaches consequences, federally defined, to rights created under state law * * *." *United States* v. *Bess*, 357 U. S. 51, 55. See also, *Fidelity & Deposit Co. of Md.* v. *New York Housing Auth.*, 241 F. 2d 142 (C. A. 2); *In Re Washington Square Slum Clearance, United States* v. *Coblentz*, 5 N. Y. 2d 300; *Morgan* v. *Commissioner*, 309 U. S. 78.

B. 1. § 36-a of the New York Lien Law created a statutory trust having as its res any payment or the right of action therefor arising from the improvement of real property for the benefit of subcontractors, mechanics or materialmen. This trust is enforceable by civil action brought by any beneficiary "* * * whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement." Diversion of the trust funds by the contractor [here, taxpayer] was constituted a felony. The trustee, was, therefore, burdened with "* * * all the obligations of a trustee of an express trust." 1942 Report, New York State Law Revision Commission, page 308. Until the decision of the New York Court of Appeals in this case, this trust was accorded as much or more dignity as an express trust. See *Waldman* v. *D & V Plumbing & Heating Contractors, Inc.*, 102 N.Y.S. 2d 787; *Corbin-Kellog Agency, Inc.* v. *Tasker*, 248 App. Div. 58, 289 N.Y.S. 156; *In re Einach's Estate*, 1 Misc. 2d 537, 146 N.Y.S. 2d 240. It is clear in the light of New York law that no beneficial interest to the funds in question in favor of the contractor [here, taxpayer] existed, and, therefore, he had no "property" or "rights to property" in the fund in question to which the federal lien could attach. The status and effect of this trust has been recognized in cases dealing with the administration of the Federal Bankruptcy Act, and the trust funds have been held to be beyond the reach of the trustee in bankruptcy under § 70a, 11 U.S.C. 110, since they are not the funds of the bankrupt contractor, this despite the priority afforded the govern-

COPY BOUND CLOSE IN CENTER

ment under § 64a(5), 11 U.S.C. 104(a)(5). *Wickes Boiler Co., Inc.* v. *Godfrey-Keeler Co., Inc.*, 121 F. 2d 415. The New York Court of Appeals in the instant case felt constrained to ignore the property rights created by New York law, stating that state law "may not be construed to affect the rights of the government or the priority of its tax lien" (R. pp. 68, 69). This result was reached by an erroneous reliance on *United States* v. *Kings County Iron Works*, 224 F. 2d 232 (C. A. 2), which has been limited by *Fidelity & Deposit Co. of Md.* v. *New York Housing Auth.*, *supra*, to the proposition that state classification of the "reserve fund as a 'trust' [did not] preclude a federal inquiry into the nature of the right thus created" (241 F. 2d at 145). The court in the *Fidelity & Deposit* case recognized that the court in *Kings County* did not inquire into whether an interest in the property in favor of the contractor was created under state law, but assumed that it did. This court recognized in the *Bess* case, *supra*, that such an assumption is unwarranted and that the inquiry above referred to is necessary. Had the court below made the necessary inquiry it would have found that no interest in the funds existed under state law in favor of the contractor, and, as a result, no lien on the fund in question could arise in favor of the government.

2. The fund in question was deposited with the court in substitution for the owner's real property under § 55 of the New York Lien Law, and the government has no more right to a lien upon the deposit-fund than it would to a lien upon the real property itself. Here, the real property did not belong to the contractor [taxpayer], and any interest the contractor [taxpayer] might have had in the real property through its mechanic's lien is specifically subordinate and inferior to the lien of subcontractors, mechanics and materialmen from the moment the lien comes into existence. § 56, New York Lien Law. The rights of the government cannot rise higher than the rights of the taxpayer, and, as a result, are subordinate to the rights of the petitioners herein.

C. 1. The court in *United States* v. *Security Tr. & Sav. Bk.*, 340 U. S. 47, erred in equating § 3670, 11 U.S.C. 3670, to R. S. 3466, 31 U.S.C.A. § 191, since the latter section affords the government priority of *payment* in a situation where it is known that the assets of the taxpayer will be insufficient to meet his obligations, while § 3670 was enacted to preserve the status quo and prevent the taxpayer from divesting himself of his assets where no known insolvency exists. All which is required is to prevent this voluntary transfer of assets by the taxpayer since should the taxpayer become insolvent or bankrupt the government is specifically afforded priority by R. S. 3466 and § 64a(5) of the Bankruptcy Act, 11 U.S.C. 104(a)(5). It was not intended to afford the federal lien priority over all other liens; the legislative report stating: "[t]here is no reason why the government should not occupy the same position with reference to liens on property as does the individual." H. R. Report No. 1018, 62nd Cong., 2d Sess., 1912. § 3670 creates a lien in favor of the government for unpaid taxes; neither that section nor § 3672 purports to establish any order of priority favoring said lien.

2. In the absence of a manifestation of congressional intent to override state law, as in this case, state law must be applied. See *Commissioner* v. *Stern*, 357 U. S. 39. Applying state law in the instant case, the mechanic's lien is entitled to prevail, as set forth above. In addition, the federal lien requires, in the implemenation of its purposes, no more effect than that afforded to the lien of a judgment creditor—the same lien granted by § 70a of the Bankruptcy Act to a trustee in bankruptcy. It is clear that under applicable law, namely New York law, the mechanic's lien is entitled to prevail. *Waldman* v. *D & V Plumbing & Heating Contractors, Inc., supra.* The lien cases decided upon the authority of Security Trust should not be applied since they deal either with insolvency situations or are based upon an incorrect interpretation of the purposes of the federal lien statutes.

COPY BOUND CLOSE IN CENTER

The present status of the law in this area leads to much uncertainty in the commercial community. Setting aside to the government all property to which the federal lien attaches (should the court determine, contrary to petitioner's contention, that the lien attached to the fund in question) without the necessity of filing said lien, prevents a subcontractor, mechanic or materialman from performing work, labor or services with confidence in the fact that he will be paid therefor. Since the fund in question arises by virtue of the efforts of the subcontractors, mechanics and materialmen, justice requires that the fund be allocated to them, not to the payment of debts of others arising from totally unrelated transactions.

Argument

"Property" or "Rights to Property"—the res belonging to a taxpayer upon which a federal tax lien may be impressed under the provisions of § 3670—may be determined only by primary reference to applicable state law. This court has recognized that there is no overriding body of substantive federal law in this area, and that the federal lien statute "creates no property rights but merely attaches consequences, federally defined, to rights created under state law * * *." *United States* v. *Bess*, 357 U. S. 51, 55.[1]

Subsequent to its decision in the instant case, the New York Court of Appeals in *In Re Washington Square Slum Clearance, United States* v. *Coblentz*, 5 N. Y. 2d 300, has likewise recognized the validity of this proposition. In the *Coblentz* case, the court found the federal statute relating to seizure of an alien's assets closely analogous, in that the statute there also relates to property or rights to property. 50 U.S.C. App. §§ 1 *et seq.* It cited two recent decisions of this court,[2] which held the determination of what consti-

[1] The government does not dispute this contention. See *Brief for the United States in Opposition, Aquilino* v. *United States*, p. 8.

[2] *Herrmann* v. *Rogers*, 358 U. S. 332.

tuted "property or rights to property" under the alie
property statute to be a matter to be determined by refer
ence to state law, as authority for its reliance upon stat
law when determining the effect of § 3670 (5 N. Y. 2d a
308). This principle was also recognized in *Fidelity an*
Deposit Co. of Md. v. *New York Housing Auth.*, 241 F. 2
142 (C.A. 2), which was cited with approval by this cour
(*United States* v. *Bess*, 357 U. S. at 55). These recen
decisions in this court make it eminently clear that th
state law of property is determinative of the "property
rights" of the taxpayer [contractor] to which a federa
tax lien may attach. Therefore, our first inquiry must b
whether a "property right" to the funds in question exist
under New York law in favor of the taxpayer.

The New York Lien Law grants two independent, con
current rights to a subcontractor, mechanic or materialma
who remains unpaid after furnishing work, services or ma
terials for the improvement of real property; (A) he i
the beneficiary of a statutory trust which has as its re
any funds, or the right of action therefor, which arise b
reason of the improvement,[3] *and*, (B) he is entitled to
lien against the real property which was improved.[4] Thes
are completely independent rights in completely independ
ent items of property; the lien is an interest in the rea
property improved; the trust res consists of the paymen
or the right to receive the payment for the improvement.
claimant may pursue, concurrently and in separate pro
ceedings, his rights in the improved property and hi
interest in the trust funds.

A. The Statutory Trust:

The fundamental "property rights" in funds or th
right of action therefor arising from the improvement o
real property by contractors, subcontractors and material
men were set forth in § 36a of the New York Lien Law

[3] § 36-a, New York Lien Law.
[4] § 3, New York Lien Law.

COPY BOUND CLOSE IN CENTER

as amended by L. 1942, c. 808, § 4. This section was repealed by L. 1959, c. 696, § 14 eff. September 1st, 1959 and new §§ 70 and 71 substitued therefor. A note (p. 974, McKinney's Session Laws of New York, 182nd Sess., Reg. Sess., 1959) explains that these sections essentially restate the provisions of former §§ 4-a, 13(7), 25-a, 25-b, 36, 36-a and 36-b "declaring that certain funds and the right to receive them are trust funds in the hands of • • • a contractor or subcontractor for the improvement of real property or a public improvement. • • •" See also "Trust Fund Provisions of the Lien Law," 1959 Leg. Doc. No. 65(F).

For the purposes of determining whether the funds in question constitute "property" or "rights to property" of the taxpayer within the meaning of § 3670, and therefore reachable by the federal tax lien, we must determine what interests in the funds are created by state law before the "property rights" referred to in said section can be ascertained. However, where no interest exists under state law, no "property" or "right to property" in the taxpayer may be created by process of interpretation of § 3670.

Section 36-a provided: "The funds received by a contractor from an owner for the improvement of real property are hereby declared to constitute trust funds in the hands of such contractor to be applied first to the payment of claims of subcontractors, architects, engineers, surveyors, laborers and materialmen arising out of the improvement. • • • [T]he trust funds shall include the right of action upon an obligation for moneys due or to become due to a contractor, as well as moneys actually received by him." § 36-a further provided for the enforcement of this trust by civil action by any beneficiary "• • • whether or not he shall have filed, or had the right to file, a notice of lien or shall have recovered a judgment for a claim arising out of the improvement." The statute identifies the trust assets, designates the class of beneficiaries, establishes a trustee, and sets forth sanctions ensuring that the trust purposes will not be defeated by diversion of the trust funds.

Diversion of the trust funds to other uses was constituted a felony: "[A]ny contractor who applies or consents to the application of such funds for any other purpose and fails to pay the claims hereinbefore mentioned is guilty of larceny and is punishable as provided in Section thirteen hundred and two of the penal law" (*ibid.*).

It is apparent from a reading of the statute that the term "trust" is not applied merely as a label—the trustee herein is burdened with "• • • all the obligations of a trustee of an express trust." 1942 Report, New York State Law Revision Commission, 308.

These trust provisions have been continually revised with but one objective, to wit, the more complete protection of the beneficiaries specified therein. The legislative history of the Trust Fund provisions is set forth in detail in "Act, Recommendation and Study relating to the Trust Fund Provisions of the Lien Law," 1942 Report, New York State Law Revision Commission 271-336.

In every case where this trust has been subject to judicial scrutiny it has been accorded even greater force than an express trust—*until the decision in the case at bar.* The New York Court of Appeals in the instant case felt compelled to reach its decision herein by the line of inapposite cases in this court commencing with *United States* v. *Security Trust* (See *post* p. 27). It stated "• • • [T]he provision in this state's Lien Law, to which respondents point—that funds received by a contractor from the owner for the improvement of real property shall be deemed 'trust funds' for the payment of subcontractors (§ 36-a; § 13, subd. [7])—may not be construed to affect the rights of the government or the priority of its tax lien." It thus decided that its own sovereign state *may not* create property rights in the funds which will be superior to those of the contractor—a proposition which is manifestly untrue as this court recognized in *United States* v. *Bess, supra,* Cf. *Erie R. Co.* v. *Tompkins,* 304 U. S. 64. Should the State of

COPY BOUND CLOSE IN CENTER

New York see fit, as it did, to withhold from the contractor any beneficial interest in the fund, the federal lien cannot attach thereto. The rights of the government cannot rise higher than the interest of the taxpayer. As this court stated in the *Bess* case, "[i]t would be anomalous to view as property subject to the lien proceeds never within the insured's [here, contractors] reach to enjoy . . ." (357 U. S. 55, 56). The New York Court of Appeals did not recognize this distinction—it assumed that a property right in the taxpayer existed and proceeded to accord priority to the federal lien.

Since its decision in the instant case, the New York Court of Appeals has recognized that "[t]itle to property and right to property are exclusively a matter of state law." *In Re Washington Square Slum Clearance, United States* v. *Coblentz,* 5 N. Y. 2d 300, 308. It is aware that "[t]he determination of what constitutes property on the date of the asserted lien by the government is a matter of State Law" (5 N. Y. 2d at 314). In addition to citing *Aetna Cas. & Sur. Co.* v. *United States,* 4 N. Y. 2d 639 and *Bess* as authority for this proposition, the court goes on to cite this case: "• • • *Aquilino, supra,* petition for certiorari granted, No. 132, Feb. 24, 1959, 27 U. S. Law Week 3231" (5 N. Y. 2d at 314). It is fair to assume that were the New York Court of Appeals again presented with this case, it would feel compelled to pass upon the question of "right to property" under state law; a question which, as will be demonstrated, must be resolved in favor of the petitioner. The court felt compelled to ignore this question in the case at bar on the grounds that state law "may not be construed to affect the rights of the government or the priority of its tax lien" (R. pp. 68-69). The court now appears to realize the error of this assumption.

In *Waldman* v. *D & V Plumbing & Heating Contractors, Inc.,* 102 N.Y.S. 2d 787, the trust fund was held beyond the reach of a judgment-creditor of the contractor seeking to levy against it through proceedings supplementary to judg-

ment. The court held that since the judgment-creditor did not establish that his claim arose for labor or materials, he had no right to the trust fund. Incidentally, this same judgment-creditor would be accorded priority over an unfiled or later filed federal lien under § 3672. This same result was reached in *Corbin-Kellog Agency, Inc.* v. *Tasker*, 248 App. Div. 53, 289 N.Y.S. 156, where the court ruled, *inter alia*, that "The money due the judgment-debtor from the owner of the property improved constituted a trust fund belonging to laborers and materialmen. Lien Law, Section 36-a." As a result, the judgment-creditor was unable to reach the debt.

In *In re Einach's Estate*, 1 Misc. 2d 537, 146 N.Y.S. 2d 240, the trustee of a similar statutory trust died insolvent. The question presented was whether the trust assets were to be segregated for the statutory beneficiaries, or whether they were subject to a charge for administration expenses. Under New York Law, administration expenses are *charges* against the estate rather than *debts*, and therefore take precedence even over the priority claims of the state.[5] Nevertheless, the court held that the trust funds were to be set aside for the statutory beneficiaries, free from charges against the insolvent estate. Certainly the state's intention to create property interests in the statutory beneficiaries to the exclusion of the trustee cannot be more eloquently expressed than this case which upholds the trust as against claims which are superior to the claims of the state itself. Furthermore, at least one New York court has accorded these administration charges priority over tax claims of the United States, on the ground that only debts are subordinated to the federal claim by 31 U.S.C. 191 (RS 3466).[6]

---

[5] *In re Einach's Estate*, 1 Misc. 2d 537, 146 N.Y.S. 2d 240, 242; *Matter of Franklin*, 26 Misc. 107, 56 N.Y.S. 858; *Matter of Ellis' Estate*, 110 Misc. 192, 179 N.Y.S. 873; *Barter* v. *Hawksworth*, 102 Misc. 242, 169 N.Y.S. 475; *Matter of Powers' Estate*, 75 Misc. 85, 134 N.Y.S. 967.

[6] *In re Stiles Estate*, 126 Misc. 715, 215 N.Y.S. 134.

COPY BOUND CLOSE IN CENTER

While *Cranford Co.* v. *L. Leopold Co.*, 298 N. Y. 676, 82 N. E. 2d 580, is no longer authority for the proposition that the mechanic or materialman is, by virtue of the Lien Law, § 36-a, a "purchaser" within the meaning of RS 3672,[7] it does further emphasize the broad reading accorded the statute by the New York courts. As set forth above, the legislature of New York has created a specific trust for the benefit of the classes set forth therein; the courts of New York have meticulously accorded this trust every effect due to an express trust, and have unfailingly granted a liberal construction to the statute. See also *Wade* v. *Nassau-Suffolk Lumber and Supply Corp.*, 275 App. Div. 864, 89 N.Y.S. 2d 294; *Rosicato* v. *Manera*, 192 Misc. 607, 81 N.Y.S. 2d 353.

In at least one respect the statutory trust is deemed more effective than an express trust. If one diverts the assets of an express trust, the assignee may show that the consideration for the transfer went to enhance the trust assets, and is entitled to credit for that amount. See Restatment, Trusts, Section 291. Also, *Bray Bros.* v. *Maine Trust Co.*, 35 N.Y.S. 2d 356. However, this application of general trust law was rejected by the New York courts in passing upon the effect of a statutory trust, as here, and the assignee is entitled to no such credit. *Century Indemnity Co.* v. *Bank of Gowanda*, 35 N.Y.S. 2d 396, affd. 263 App. Div. 1068, 35 N.Y.S. 2d 463.

As this court has indicated, § 3670 does not *create* property rights in the taxpayer, and where, as here, none exist under state law, the federal lien does not attach to the property in question.

For the purposes of federal treatment of this statutory trust, the question whether the trust res is "property" of the contractor to which a trustee in bankruptcy takes title under Section 70a of the Bankruptcy Act, 11 U.S.C.

---

[7] This is contrary to *United States* v. *R. F. Ball Construction Co.*, 355 U. S. 587.

110, upon the contractor's bankruptcy, is virtually indistinguishable from the case at bar. In *neither* case are we concerned with the relative priority of a federal or private lien; in *both* cases the sole concern is whether the trust assets constitute "property" of the contractor. This court has recently recognized the similarities in construction of the term "property" in § 3670 and in the Bankruptcy Act, citing its construction in the latter act as authority for its construction in the former. *Bess* case, *supra*. The priority granted the federal claim for taxes in Section 64a(5) of the Bankruptcy Act, 11 U.S.C. 104(a)(5), when read in conjunction with the provisions of § 70a giving the Trustee in Bankruptcy the lien of a judgment creditor on all the assets of the bankrupt, is closely analogous to the lien granted the federal claim for taxes by § 3670. In both situations the question of relative priority of lien between the government and a third party is extraneous to the issue—relative rights to property between the contractor and a third party are the questions presented.

In *Wickes Boiler Co., Inc.* v. *Godfrey-Keeler Co., Inc.*, 121 F. 2d 415 (reversing 116 F. 2d 842), certiorari denied, 314 U. S. 686, the Second Circuit held that the trust res is *not* a part of the bankrupt's estate when the contractor becomes bankrupt.[8] The government contended therein that such a holding contravened the priority of § 64a(5) of the Bankruptcy Act, 11 U.S.C. 104(a)(5), and such contention was rejected. The court recognized that, as here, the question presented was one of property rights rather than

[8] The Second Circuit initially held that a genuine trust was not created by this statute, 116 F. 2d 842. This holding was based upon the court's reading of New York cases indicating that the trust was not effective until a lien was filed. This is consistent with the government's argument in the tax lien cases that the federal lien is superior to any "inchoate" interest. However, on rehearing the court reversed itself on the basis of later precedent indicating that the filing of a lien was not a prerequisite to the enforcement of the trust. The court's second view of the New York cases was confirmed by statutory amendment in 1942, specifically providing for enforcement of the trust whether or not a lien was, or could be, filed. New York Lien Law, § 36-a.

COPY BOUND CLOSE IN CENTER

priority. The holding in the *Wickes* case is in accord with both earlier and more recent bankruptcy cases in the New York district courts, all holding the trust assets immune from the claim of the trustee in bankruptcy.[9]

The federal Bankruptcy Act, granting priority to debts owed to the federal government for taxes, demands uniformity of application among the states in a degree equal to § 3670. This requirement is satisfied in both cases by reliance upon the state law of property, once the court is satisfied that the state law is established without reference to the federal law, and is of general application to all transactions within the state. The fact that the state sees fit to protect certain classes of interests is binding upon the federal government to the extent that the state creates property interests in the preferred class, since these property interests govern in the absence of a controlling federal statute to the contrary. In the instant case, there is no federal statute defining "property rights." Should this court, in the absence of statutory direction to the contrary, choose to ignore the contractor's lack of a property interest in the trust res, and permit the federal lien to attach, a series of anomalous results could occur which would serve to frustrate both federal policy as set forth in §§ 3670-72, and state policy as set forth in the Lien Law—a result which could hardly be less satisfactory. If such were the law, and a $10,000 obligation were owing from an owner for the improvement of real property, under New York Law it would be immune from claims of judgment-creditors of the contractor until all subcontractors, mechanics and materialmen had been paid. Should, in addition, a judgment be outstanding against the contractor in the sum of $10,000, and should it exist prior to the filing of a federal tax lien against the "property" or "rights to property" of the contractor, under § 3672 it

[9] *In re Treister & Son, Inc.*, 145 F. Supp. 144, 146 (S.D.N.Y.); *In re Heintzelman Construction Co.*, 34 F. Supp. 109 (W.D.N.Y.); *Albert Pick Co., Inc.* v. *Travis*, 6 F. Supp. 486 (E.D.N.Y.).

would take precedence over a tax lien. A situation would exist which has been termed "circular priority"[10] whereby the federal lien has priority over the beneficiary of the trust, who, in turn, has priority over the judgment creditor. The circle is complete since the judgment creditor has priority over the federal lien. In a suit by the government to enforce its lien, the government is precluded from recovering by existence of the judgment creditor, who in turn cannot recover since under state law he has no interest in the fund. The ultimate recipient would be the beneficiary under the trust, whom, it has been established, is in a position inferior to the government. Many other combinations can be anticipated, all of which have comparably bizarre results. These results go to confirm the thesis that the application of the federal lien *must* be determined by reference to state property rights, which must govern the result in the case at bar.

The New York Court of Appeals in the instant case relied upon *United States* v. *Kings County Iron Works, Inc.*, 224 F. 2d 232. On its facts, *Kings County* is admittedly indistinguishable from the case at bar. Although the Second Circuit there recognized the bases for prevailing over the federal lien, namely (1) by establishing that the fund in question was not the property of the taxpayer, or (2) bringing the claim within the classes protected by § 3672, or (3) perfecting the interest to the extent required to prevail under the theory that the "first in time is first in right", it did not feel that the subcontractor came within the protection of either of said three situations. However, the Second Circuit itself recognized, in its later decision in *Fidelity & Deposit Co. of Maryland* v. *New York Housing Authority*, 241 F. 2d 142, and cited with approval by this court in *United States* v. *Bess, supra*, that "The Court [in *Kings County*] did not inquire whether the state had created a right [in the defaulting taxpayer]. It assumed

[10] Final Report of the Committee on Federal Liens, ABA, presented to House of Delegates February 23, 1959, p. 28.

COPY BOUND CLOSE IN CENTER

hat it did . . ." (241 F. 2d at 145). Thus, by the Second Circuit's own opinion, *Kings County* is not authority for he proposition for which it was cited by the New York ourt where that court states "It was asserted against the ontractual obligation of Bottone to Fleetwood, against Bottone's indebtedness to the latter, and, quite obviously, ithin the statutory terms personal 'property or rights to such] property' belonging to the taxpayer." The New ork court similarly erred in that it did not inquire into hether a property right actually existed in favor of Fleet-ood—it failed to recognize that the indebtedness itself ue from Bottone to Fleetwood constituted the res and orpus of the statutory trust. In neither case did the court nvestigate whether the property belonged to the taxpayer *ut assumed that it did*, the court in *Kings County* stating: But it seems extremely doubtful to us that any trust fund evice could ever supersede federal tax liens, even if the tate purported to omit all perfecting requirements." It s submitted that this is precisely the reasoning, as echoed y the New York Court of Appeals, which this court ruled rroneous in *Bess* by recognizing the necessity to look o state concepts of property when applying to federal en statutes.

The Second Circuit in *Fidelity & Deposit* dealt with a ituation which, although distinguishable on its facts from he instant case, is virtually indistinguishable in theory. n that case, upon default by the contractor, the surety n a bond guaranteeing the performance by the contractor n a public improvement came in and completed the job. contest ultimately arose between the surety and the ederal government, the latter claiming a lien against the roceeds of the contract for taxes owing by the contractor. he court there upheld the surety and decided that the nds were not the property of the taxpayer within the rview of § 3670. In the course of its decision, the court ealt with *Kings County*, and limited the holding of the tter case to the proposition that the state classification f the "reserve fund as a 'trust' [did not] preclude a

federal inquiry into the nature of the right thus created (241 F. 2d at 145). The decision in *Kings County*, as limited, is in accord with the decisions of this court.

The factual distinction in *Fidelity & Deposit* is the clause in the prime contract making the contractor's right to receive payment under the contract contingent upon the prior payment of all subcontractors and materialmen. This, the court felt, effectively deprived the contractor of any "right to property" until the condition precedent was performed. It is significant that the government did not seek review of this decision. The holding has since been followed by the New York Court of Appeals in *Aetna Cas. & Sur. Co.* v. *United States*, 4 N. Y. 2d 639, just as *Kings County* was followed in the case at bar.

The continued existence of these two decisions will lead to but one conclusion—private individuals are able to do by contract that which the state is unable to accomplish by statute. A well-informed owner or subcontractor need only insist upon the inclusion of a "*Fidelity & Deposit* clause" in his contract and any claim of the government for taxes owed by the contractor will be effectively defeated. However, this is not the individual whom the state primarily seeks to protect. The state seeks to protect the uninformed mechanic who cannot obtain legal counsel perspicacious enough to insert a "*Fidelity & Deposit* clause," or the poor one whose bargaining power is not sufficient to compel its insertion. The present state of the law operates also to hamper the small contractor whose resources do not permit the payment of subcontractors from his own funds, but who cannot obtain the most profitable contracts unless he is prepared to do so, since the owner will be sure to require the protective clause. We are therefore met with the anomalous situation where private individuals with adequate resources may protect themselves, while the state is unable by statute to protect the common carpenter or plumber whose bargaining position cannot command protection, and who is less prepared to sustain a loss.

COPY BOUND CLOSE IN CENTER

In the instant case, the government contends that its lien came into existence, in accordance with § 3670, from the time the assessment lists were received by the District Collector of Internal Revenue, and immediately attached to any property of the taxpayer thereafter acquired. Here, the lien purportedly arose prior to the time the premises were purchased by the owner, prior to the time the prime contract was signed, and prior to the time the subcontractors and materialmen performed their respective services. If that is so, the petitioners herein at no time had any prospect of being paid for their efforts, although they had no way to ascertain this fact. The assessment procedure is wholly internal within Internal Revenue Service, and is not a matter of public record. At all times the only product of their labors would be the payment of another party's indebtedness to the government. All this stems from the fact that the prime contract herein did not contain a clause affirming that which was already true as a matter of state law, that the contractor could receive no benefit until the beneficiaries of the trust were paid. The sole purpose of the safeguards afforded the mechanic under state law—the assurance that he alone will receive the fruits of his labors, is subverted by the decision in the instant case.

Two facets of the trust provisions are frequently resorted to when one seeks to establish that the mechanic or materialman holds merely an inchoate lien. First, it is claimed that, since the amounts due to the beneficiaries are not identified and may not consume to entire corpus of the trust, the property interest remains in the contractor. Secondly, the fact that an action to enforce the trust must be commenced within one year from the completion of the improvement is taken as evidence that further action is required of the beneficiary before his interest is perfected. The application of fundamental concepts of trust law indicates that reliance upon these provisions to deny the existence of a valid trust is misplaced.

It is fundamental that a trust may be created in favor of a class. The trust is valid, even though the trustee or another person has authority "to determine which member or members of the class shall take and in what proportions they shall take." Scott on Trusts, 1956 Ed., Vol. II, § 120. In such a case, no member of the class is assured that he will receive a benefit from it, since the entire assets may be allocated to another beneficiary, but he nevertheless may bring a representative action to enjoin or redress a breach of trust (*Ibid.*). Should the trust be of limited duration, and should the trust assets not be distributed within the specified period, in the absence of other provisions a resulting trust arises in favor of the settlor. "A resulting trust arises where property is transferred upon a trust and it does not appear from the trust instrument whether the accomplishment of the purposes of the trust will exhaust the entire estate, *but it ultimately turns out* that the whole of the trust estate is not needed for the accomplishment of the purposes." Scott on Trusts, 1956 Ed., Vol. IV, § 430.2. (Emphasis supplied.)

Applying these fundamentals to the case at bar, § 36-a establishes a trust for the benefit of mechanics, materialmen, etc.—a specific class. The trust assets are identified, and the trust is to endure until one year after completion of the improvement. Initially, it is impossible to determine if the trust assets will all be needed to meet the claims of the beneficiaries. Nevertheless, until they are all satisfied, the trustee holds bare legal title. After all the beneficiaries are satisfied in accordance with the terms of the trust, if a surplus exists, a resulting trust will arise in favor of the contractor and a beneficial interest rests in him. Not until that occurrence—the payment of all beneficiaries—does the contractor obtain any beneficial interest in the surplus of the funds over the claims of the beneficiaries.

The statutory trust established by New York law is clearly in consonance with the basic principles of trust

COPY BOUND CLOSE IN CENTER

law applicable to express trusts. Those basic principles further establish that all "property rights" to the funds in question are vested in the beneficiaries during the duration of the trust, not the trustee. Any contingent, residual rights which may come into existence upon the termination of the trust have no effect upon the "property rights" to the funds in question during the duration of the trust.

The trust assets having been proven insufficient to satisfy the rights of the trust beneficiaries, no resulting trust could arise in favor of the contractor. In this case, it is difficult to conceive how "rights to property" in favor of the contractor can be unearthed, absent the necessary interest created by state law. Only non-recognition of the interests created by state law can result in a decision in favor of the government.

The cases relied on by the government and the court below all dealt with competing claims to property which was *admittedly* that of the taxpayer. In such instances, the question of whether the competing claimant's interest is sufficiently perfected to prevail is properly before the court. Here we question that which was assumed in those cases—the taxpayer's right to the property. Consequently, a different approach is necessary. The claimant need not establish that the property is his or that his interest is perfected in order to prevail over the government. He must, rather, establish that the property is *not* that of the taxpayer. Therefore, even should this court determine that the interest of petitioner is not perfected, which petitioner denies, decision should nevertheless be rendered in his favor on the ground that under New York Law, the taxpayer has no beneficial interest in the funds, and the government, claiming through him, is not entitled to the fund in question.

The 1959 revision of the trust fund provisions[11] "*re-state*[*d*] the present provisions defining trust funds and

[11] L. 1959, C. 696.

trust purposes, specifie[d] an additional category of trust funds, and recognize[d] certain necessary payments as being within the trust purposes"[12] (emphasis supplied). For present purposes, we are not concerned with the impact of any additions or extensions, save insofar as they indicate a continuing legislative purpose to afford maximum protection to the statutory beneficiaries, and to ensure that funds arising by virtue of an improvement go to pay the expenses thereof. Nor are we concerned with changes governing the administration of the trust, except to note that they go to further safeguard against misapplication of trust assets. However, the restatement of certain provisions of former § 36-a in § 70 of the revised statute, along with the specific recognition in the revised statute of the applicability of fundamental trust principles, confirms the intent of the legislature and the courts, insofar as prior judicial decisions are recognized by statute, to vest the "property rights" to the funds in question in the beneficiaries until the termination of the trust. The statute now specifically provides: "Upon termination of the trust by payment or discharge of all the trust claims, the beneficial interest in any remaining assets shall vest in the owner, contractor or subcontractor, as the case may be" (§ 70(3)). As heretofore demonstrated (pp. 21-23), this same result is reached by the application of basic trust principles. Section 70(3) does not change the law—it merely embodies in the statute those long standing principles of trust law which govern the disposition of the case at bar.

If the taxpayer in the instant case were the owner of the real property improved, and his own assets were the only source of payment, prior decisions of this court would indicate that the federal tax lien would be entitled to

---

[12] *Trust Fund Provisions of the Lien Law*, 1959 Leg. Doc. No. 65(F).

COPY BOUND CLOSE IN CENTER

priority.[13] In such a case there would be no trust funds in existence, and the only recourse open to the mechanic or materialman would be through the enforcement of his lien on the real property. In that case, we would be required to ascertain the relative priority of the competing liens. In the instant case, any priority afforded the federal lien, by statute or otherwise, is not relevant since the basic element essential to the existence of the federal lien—a "right to property" in the taxpayer, is missing.

B. The Mechanic's Lien:

If the federal tax lien and the mechanic's lien under state law attach to the identical property, a contest arises wherein the order of precedence must be established. However, in the case at bar, the two liens do not encumber the same property. The federal lien attaches to all "property" or "rights to property" of the taxpayer; the mechanic's lien is impressed upon the real property improved. These may be identical where the taxpayer and the owner are the same individual, but where, as here, the taxpayer is a contractor who does not own the real property improved, the liens attach to separate items of property and it is not necessary to establish an order of precedence. Petitioner does not at this time contest the validity or priority of the federal lien upon all the "property" or "rights to property" of the taxpayer.[14] Petitioner contends that the fund in question is not such a property right of the taxpayer.

The fund in question was deposited in court by Bottone, owner of the real property improved and against which the subcontractor filed its lien and said monies were in substitution of the real property. The government had no lien against the *real property*—which was *not*, at any time, the

---

[13] *United States* v. *Security Tr. & Sav. Bk.*, 340 U. S. 47; *United States* v. *Vorreiter*, 355 U. S. 15, et al. Petitioner questions the propriety of these decisions (see *post*, pp. 27-29), but in the consideration of the "trust fund" doctrine they are not relevant.

[14] See *post*, pp. 27-34.

property of the contractor-taxpayer, nor did it have, or could it have had, a lien against the fund deposited in substitution of the real property. The Appellate Division below, recognized this stating "The funds deposited by Bottone were in this case substituted for her property . . ." (R. p. 64).[15] Since the federal lien clearly did not attach to any real property belonging to Bottone, our inquiry must be directed to the relative interests of the contractor and the subcontractor to the real property. The government's lien, although perfected, does not vary or enlarge the interest of the taxpayer to which it attaches, and if, under New York Law, the subcontractor's rights are superior to those of the contractor-taxpayer, he must prevail over the federal lien.

In addition to the contractor's right to sue on the contract in his capacity as trustee, he has a lien upon the real property improved. This lien may be perfected by filing, and may be foreclosed and satisfied by the sale of the real property. An identical right exists in favor of the subcontractor. The relationship between these rights is set forth in § 56 of the Lien Law. Pursuant to that section, the subcontractor is entitled to priority of payment regardless of whether he shall have filed his lien.[16] Therefore, the right of the contractor was always subject and subordinate to the interest of the subcontractor, and even though the federal lien attached to the contractor's right, under the principles recognized in the *Bess* case that contractor's right cannot be elevated over the interest of the subcontractor. The government, having no lien against the *real property* involved, has no lien against the funds deposited in substitution therefor. Under these circumstances, the government can be in no better position than Fleetwood,

[15] § 55, New York Lien Law.

[16] § 56 does not specify that the subcontractor must have filed a lien. It merely states that he shall be paid "before any part of said proceeds is paid to the person for whom he has performed such labor or furnished such materials."

COPY BOUND CLOSE IN CENTER

the contractor would have been if its interest was not subject to the federal lien, and is entitled only to what surplus exists after the mechanic's lienors have been paid—in this case, nothing. Thus, whether the fund be viewed as the proceeds of the contract between Bottone and Fleetwood, or as a deposit in place of Bottone's real property, the petitioner's herein are entitled to receive it to the exclusion of the government.

C. Lien Priority:

§ 3670, in establishing a lien in favor of the government for unpaid taxes, makes no reference to any order of priority to be accorded said lien. §§ 3671 and 3672 merely specify the duration of the lien, and specify certain classes who are protected from the impact of the lien unless the federal lien is first recorded in the place designated by law. The only conclusion fairly inferable from a reading of these sections in conjunction with each other is that the government is to possess a fully perfected lien, against the *property of the contractor-taxpayer,* effective against all except those specified in § 3672, without filing.

The next question to be met, should this court disagree with petitioner's contention that no "property" or "right to property" exists herein for the federal lien to attach to, is the effect to be given this fully perfected lien held by the government, and what law is to determine its effect.

This court has held in *United States* v. *Security Tr. & Sav. Bk.,* 340 U. S. 47, that the federal lien is to be accorded priority over any other lien which is not fully perfected as of the date that the federal lien attached. In that case it was argued by the government that § 3670 was, essentially, *in pari materia* with R. S. § 3466, 31 U.S.C.A. § 191, and this proposition, *unopposed by the respondent who failed to file a brief or argue and submitted on the record,* was apparently accepted by the court. The two sections should not have been equated to each other. R.S.

§ 3466 specifically established a priority of *payment* upon the insolvency of a taxpayer in favor of the government. Stringent provisions were necessary to protect the rights of the government in a situation wherein it was apparent that the assets of the taxpayer would not be sufficient to pay all of his debts, and as a result, a stringent statute was enacted by Congress. The Court in *Security Trust* read these provisions into a statute, namely § 3670, enacted to cope with a problem which presents no such urgent fact situation. At the time the federal lien under § 3670 attaches, there is no clear indication that the taxpayer will be unable to pay his debts. If such situation should arise, the government still has recourse, either under § 3466 or through the priority provisions incorporated in the Bankruptcy Act. There is no necessity to accord the federal lien such preferential treatment at this time, nor is there any indication that the Congress intended it to be so. In Mr. Justice Jackson's concurring opinion in *Security Trust*, he quotes the House Report accompanying the 1913 amendment which added in essence the provisions contained in § 3672 (37 Stat. 1016, Ch. 166).[17] That report referred to the scope accorded § 3670 with great trepidation, and made reference to its impact to support the necessity for ameliorating legislation. However, that report, as quoted by Mr. Justice Jackson, made reference only to the scope of the property rights to which the federal lien attached, not to the effect of that lien once it was in existence. § 3672 required that the lien be recorded in order to protect certain classes who were in effect transferees of the taxpayer's interest, and prevent them from giving value for the transfer of an interest which was secretly encumbered. § 3672 alleviated problems arising from the lien's secrecy, and did not relate to any priority to be afforded to it. The classes specified therein did not have to contend with the federal lien. The section did not purport to establish a priority in favor of the federal lien over

[17] H. R. Report No. 1018, 62nd Cong. 2d Sess. 1912.

COPY BOUND CLOSE IN CENTER

all other liens in existence at the time it arose. In fact, the House Report also stated "There is no reason why the Government should not occupy the same position with reference to liens on property as does the individual."[18] This is a clear indication that the court erred in equating § 3670 with § 3466 to establish a priority in favor of the government.

In the application of the federal lien, it has already been established that in determining the property of the taxpayer to which it attaches, reference must be made to the state law of property. Likewise, when determining the impact of a federal lien, there is an interplay between federal and state law. The federal law lien statutes do not purport to enact a complete system, but are superimposed upon, and only partially override, the state property law. Absent a manifestation of congressional intent to override the state property law, the latter must prevail. "Since Congress has not manifested a desire for uniformity of liability, we think that the creation of a Federal decisional law would be inappropriate in these cases. In diversity cases, the Federal Courts must now apply State decisional law in defining State-created rights, obligations and liabilities. *Erie R. Co.* v. *Tompkins,* 304 U. S. 64." *Commissioner* v. *Stern,* 357 U. S. 39, 45. Neither in the statute establishing the federal lien nor in the accompanying legislative reports does one find evidence of such intention to create uniformity of liability. As a result, once, as the government contends herein, a federal lien for taxes arises, it is still necessary to direct our attention to the effect to be given this lien under the state law of property.

The federal lien was not meant to ensure that the government receive the proceeds of the property to the exclusion of all others. As demonstrated previously, the factual situation existing at its inception does not warrant such stringent measures. In the case at bar, the federal

---

[18] H. R. Report No. 1018, 62nd Cong. 2d Sess. 1912.

lien purportedly arose over two years before the fund in question arose, but the taxpayer was still in business and operating. The lien was rather intended to fulfill the purpose which likewise justifies the existence of liens in favor of private individuals; to wit, preventing the taxpayer from divesting himself of his assets so that he will not be able to pay his indebtedness. The government is already preferred in that in most instances its lien need not be filed—no further preference is required to protect the government's interest. The existence of the federal lien preserves the status quo, and gives the government time in which to proceed with the enforcement of its claim. This is all which Congress intended, and places the government on par with all other lienors without the necessity of filing. At a later date, should the taxpayer become insolvent or bankrupt, the statutes governing those situations grant the necessary priorities to afford the government what Congress felt were adequate safeguards for the collection of its taxes. It ensures payment from the assets belonging to the taxpayer, rather than requiring third parties in effect to pay the debt due to the government.

A number of cases have been decided by this court in reliance upon the authority of *Security Trust*. Few of them are in point in the case at bar. *United States* v. *Gilbert Associates*, 345 U. S. 361, involved the federal tax lien in contest with a town tax lien. The court decided that the town was not a purchaser under § 3672, which does not concern us here. The taxpayer there was insolvent, and the government was accorded priority under R. S. § 3466. As a result, although a lien contest was involved, the facts were so dissimilar from the instant case that different statutes and principles of law governed.

In *United States* v. *City of New Britain*, 347 U. S. 81, this court recognized the distinction set forth above; that "the federal statutes do not attempt to give priority in all cases to liens created under the paramount authority

COPY BOUND CLOSE IN CENTER

of the United States." 347 U. S. at 84. It was further aware that the United States has priority in insolvency when all the property of the debtor is involved. The court decided that the United States was entitled to prevail, not by virtue of any intrinsic priority, but on the ground that "the first in time is the first in right." (347 U. S. at 35.) It was in this respect that the court erred. It supports this ruling by stating "There is nothing in the language of § 3672 to show that Congress intended antecedent federal tax liens to rank behind any but the specific categories of interests set out therein, and the legislative history lends support to this impression." (347 U. S. at 88.) The court did not recognize that § 3672 did not directly concern the priority of liens, but rather specified situations in which the liens would not attach. The legislative history, as has been pointed out (p. 29) goes to defeat the court's thesis rather than support it. The court, in awarding the federal lien priority over any lien subsequently arising, chose to override state law in the absence of any federal statute to the contrary. The legislative purpose, to prevent the taxpayer from divesting himself of his property, does not require this preferential treatment—the lien of a judgment-creditor, which exists for the identical purpose, is all which the exigencies of the situation demand.

The court in *United States* v. *Acri*, 348 U. S. 211, *United States* v. *Liverpool & L. & G. Ins. Co.*, 348 U. S. 215, and *United States* v. *Scovil*, 348 U. S. 218, relied upon the reasoning set forth above. Inquiry was made to discover whether the opposing lien was "choate" or "inchoate" at the time the federal lien arose on the theory that only a fully perfected, "choate" lien existing when the federal lien arose would prevail over the federal lien. *United States* v. *Colotta*, 350 U. S. 808, *United States* v. *White Bear Brewing Co.*, 350 U. S. 1010; *United States* v. *Vorreiter*, 355 U. S. 15, were *per curiam* decisions apparently decided on the same basis. This doctrine has carried to the

point where only a lien which needs nothing further toward its liquidation and enforcement will be considered "choate," unless it is one specifically mentioned in § 3672. Apart from those liens covered by § 3672, for a private individual, such a lien *can not* exist. It is the nature of the lien that it merely preserves the status quo with a view to eventual enforcement of the underlying claim. It represents security for the payment of an outstanding debt.[19] As such, the recent cases in this court prevent it from becoming sufficiently perfected to prevail over the federal tax lien, unless it is a lien created by another sovereign body which accords its lien similar preference. And then, the courts state that no rule of preference enacted by the state can defeat the federal lien.[20] There is a tenuous semantic difference between stating that the federal lien is entitled to priority, or saying that "the first in time is the first in right," and then deciding that only the government can come first. No such result was intended by Congress, and the criterion of "perfection" or "inchoateness" should not be applied in this case.

Consistent with the legislative purposes, it is more appropriate to accord the government the lien of a judgment-creditor under state law. This serves to preserve the status quo, and prevents the taxpayer from divesting himself of the specific property to which the lien has attached. Should further recourse be required by the government if it ultimately develops that the taxpayer cannot meet his obligations, R. S. § 3466 and the Bankruptcy Act provide additional safeguards by way of preferential treatment. It is your petitioner's contention that this is all that is required by the terms of § 3670, and by the underlying legislative purpose embodied therein.

As has been established previously (pp. 13-14), the mechanic's lienor under New York Law is entitled to prevail

---

[19] Black's Law Dictionary, 3rd Ed.

[20] *United States* v. *Kings County Iron Works, Inc.*, 224 F. 2d 232.

COPY BOUND CLOSE IN CENTER

over the liens of judgment-creditors regardless of when those liens arose.[21]

The purposes of the protection afforded subcontractors and materialmen under New York law are clear. It is intended that all monies earned and accruing by reason of their work, labor and materials shall be, at all times, available for payment of their claims before any of such monies are available to the contractor [taxpayer], directly or indirectly.

In the present state of the law, as embodied by the decision of the court below, only the well-advised subcontractor who inserts a "*Fidelity and Deposit* clause" may prevail over the federal lien. This puts the burden of the federal lien on the less affluent subcontractor or materialman who cannot bear it, and benefits the government little, since where large funds are involved it may be anticipated that astute counsel will be retained who will put the fund beyond the reach of the government merely by inclusion of such a "*Fidelity and Deposit* clause."

The application of the decision in the court below also will operate to hinder the government in the long run, since it will make it more difficult for a contractor who is temporarily pressed for funds to obtain new work, the profits from which would go to pay his taxes. The contractor in default in the payment of his taxes will find it difficult to find subcontractors and materialmen who will extend credit to him, and render it well-nigh impossible for him to obtain a bond when required since the surety will know he is faced with the possibility of being subordinated to a secret federal lien. As a result, the contractor may be strangled financially, with no concomitant gain to the government.

---

[21] *Waldman* v. *D & V Plumbing & Heating Contractors, Inc.*, *supra*; *Corbin-Kellog Agency, Inc.* v. *Tasker*, *supra*.

A reversal of the judgment below will be in consonance with governing law as expressed in both this court and in the courts of the State of New York, and will also add a certainty of result to commercial transactions between contractors and subcontractors and materialmen which is clearly in the public interest.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that the judgment of the New York Court of Appeals below should be reversed and that judgment herein should be rendered in favor of the petitioners; or, that the cause should be remanded to the New York Court of Appeals for consideration and determination of the contractor's interest in the fund in question, if any, under the established and applicable doctrines of the New York law of property; and, if such interest be found, for determination of whether such interest constitutes "property" or "rights to property" within the meaning of § 3670, 11 U.S.C. 3670.

Respectfully submitted,

CHARLES S. FRIEDMAN,
Attorney for Petitioners,
Aquilino & Spero.

JACOB I. GOODSTEIN,
Attorney for Petitioner,
Colonial Sand & Stone Co., Inc.

HAROLD M. EDWARDS,
KENNETH J. BRESKIN,
Of Counsel.

COPY BOUND CLOSE IN CENTER

APPENDIX

(a) The Federal Lien for Taxes.

Section 3670 of the Internal Revenue Code of 1939, 26 U.S.C. (1952 ed.) 3670, 53 Stat. 448, now appearing as Section 6321 of the Internal Revenue Code of 1954, 26 U.S.C. (1952 ed., Supp. II) 6321, 68A Stat. 779, provides as follows:

LIEN FOR TAXES

> If any person liable to pay any tax neglects or refuses to pay the same after demands, the amount (including any interest, penalty, additional amount, or addition to such tax, together with any costs that may accrue in addition thereto) shall be a lien in favor of the United States upon all property and rights to property, whether real or personal, belonging to such person.

Section 3671 of the Interial Revenue Code of 1939, 26 U.S.C. (1952 ed.) 3671, 53 Stat. 449, now appearing as Section 6322, 26 U.S.C. (1952 ed., Supp. II) 6322, 68A Stat. 779, provides as follows:

PERIOD OF LIEN

> Unless another date is specifically fixed by law, the lien shall arise at the time the assessment list was received by the collector and shall continue until the liability for such amount is satisfied or becomes unenforceable by reason of lapse of time.

Section 3672 of the Internal Revenue Code of 1939, 26 U.S.C. (1952 ed.) 3672, 53 Stat. 450, now appearing as Section 6323, 26 U.S.C. (1952 ed., Supp. II) 6323, 68A Stat. 779, provides as follows:

VALIDITY AGAINST MORTGAGEES, PLEDGEES, PURCHASERS, AND JUDGMENT CREDITORS

(a) INVALIDITY OF LIEN WITHOUT NOTICE.—

Except as otherwise provided in subsection (c), the lien imposed by section 6321 shall not be valid as against any mortgagee, pledgee, purchaser, or judgment creditor until notice thereof has been filed by the Secretary or his delegate—

(1) UNDER STATE OR TERRITORIAL LAWS.—In the office designated by the law of the State or Territory in which the property subject to the lien is situated, whenever the State or Territory has by law designated an office within the State or Territory for the filing of such notice; or

(2) WITH CLERK OF DISTRICT COURT.—In the office of the clerk of the United States district court for the judicial district in which the property subject to the lien is situated, whenever the State or Territory has not by law designated an office within the State or Territory for the filing of such notice; or

(3) WITH CLERK OF DISTRICT COURT FOR DISTRICT OF COLUMBIA.—In the office of the clerk of the United States District Court for the District of Columbia, if the property subject to the lien is situated in the District of Columbia.

(b) FORM OF NOTICE.—

If the notice filed pursuant to subsection (a) (1) is in such form as would be valid if filed with the clerk of the United States district court pursuant to subsection (a) (2), such notice shall be valid notwithstanding any law of the State or Territory regarding the form of content of a notice of lien.

COPY BOUND CLOSE IN CENTER

(c) EXCEPTION IN CASE OF SECURITIES.—

(1) EXCEPTION.—Even though notice of a lien provided in section 6321 has been filed in the manner prescribed in subsection (a) of this section, the lien shall not be valid with respect to a security, as defined in paragraph (2) of this subsection, as against any mortgagee, pledgee, or purchaser of such security, for an adequate and full consideration in money or money's worth, if at the time of such mortgage, pledge, or purchase such mortgagee, pledgee, or purchaser is without notice or knowledge of the existence of such lien.

(2) DEFINITION OF SECURITY.—As used in this subsection, the term "security" means any bond, debenture, note, or certificate or other evidence of indebtedness, issued by any corporation (including one issued by a government or political subdivision thereof), with interest coupons or in registered form, share of stock, voting trust certificate, or any certificate of interest or participation in, certificate of deposit or receipt for, temporary or interim certificate for, or warrant or right to subscribe to or purchase, any of the foregoing; negotiable instrument; or money.

(d) DISCLOSURE OF AMOUNT OF OUTSTANDING LIEN.—

If a notice of lien has been filed under subsection (a), the Secretary or his delegate is authorized to provide by rules or regulations the extent to which, and the conditions under which, information as to the amount of the outstanding obligation secured by the lien may be disclosed.

(b) The New York State Lien Law.

New York Lien Law, Section 36-a, L. 1942, c. 808, Sec
tion 4, provided as follows:

> The funds received by a contractor from an owne
> for the improvement of real property are hereby de
> clared to constitute trust funds in the hands of suc
> contractor to be applied first to the payment of claim
> of subcontractors, architects, engineers, surveyor
> laborers and materialmen arising out of the improve
> ment, and to the payment of premiums on surety bon
> or bonds filed and premiums on insurance accruin
> during the making of the improvement and any con
> tractor and any officer, director or agent of any con
> tractor who applies or consents to the application o
> such funds for any other purpose and fails to pay th
> claims hereinbefore mentioned is guilty of larceny an
> punishable as provided in section thirteen hundred an
> two of the penal law. Such trust may be enforced b
> civil action maintained as provided in article three-a o
> this chapter by any person entitled to share in th
> fund, whether or not he shall have filed, or had th
> right to file a notice of lien or shall have recovered
> judgment for a claim arising out of the improvemen
> For the purpose of a civil action only, the trust fund
> shall include the right of action upon an obligation fo
> moneys due or to become due to a contractor, as we
> as moneys actually received by him.

COPY BOUND SO AS TO CLOSE IN CENTER